Internal Revenue Service
memorandum

date: MAY 05 1986

to: Chief, Appeals Office
Newark, NJ
Attention: Philip Glackin

from: Chief, Corporation Tax Branch CC:C:C

subject: [redacted]
E.I.N.: [redacted]

Year(s) or period(s) involved: [redacted]

☒ Attached is our memorandum in response to your request for technical advice in the case described above.

☐ Case returned for further development. (See remarks below).

Remarks:

The attached memorandum comes within the scope of section 6110 of the Code and will accordingly be made open to public inspection in the National Office Public Reading Room. This will normally occur 75-90 days after the date of mailing of the enclosed "Notice of Intention to Disclose." Please see IRM 4550, which discusses the procedures to be followed in furnishing the taxpayer with various documents and advising the National Office of the commencement of this 75-90 day period.

A copy of this transmittal memorandum should not be furnished the taxpayer.

Attachments:
Copy of this memorandum
Original and two copies of Technical Advice memorandum
Copy of Technical Advice memorandum edited for 6110 purposes
Copy of Notice of Intention to Disclose
Copy of Technical Advice dating schedule
Submitting office case file (if any)
Distribution: Copy of each memorandum to: (Check appropriate blocks)

☐ ARC (Examination) _____ Region ☒ Reg. Dir. of Appeals, Mid-Atlantic Region

☐ CP:E:E:E ☒ CP:AP

This form is *not* to be used to transmit Technical Advice memorandums involving civil fraud, criminal investigations, or jeopardy or termination assessments. See IRM (11)1(12)5:(6).

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Form M-6000 (Rev. 7-81)

Attachment to Form M-6000

This is in response to your request for Technical Advice in the above named case. At issue is whether the taxpayer's losses on the cancellation of its forward foreign currency contracts yields capital loss or ordinary loss.

In the instant case, the taxpayer or its subsidiary has cancelled a contract to sell foreign currency in the future. If this cancellation is merely an extinguishment, the loss would be ordinary. However, if the cancellation can be deemed equivalent to a sale or exchange, the loss may be considered capital.

Rev. Rul. 75-527, 1975-2 C.B. 30, holds that the amounts received on the termination of a heating service supplier's contract were not from a sale or exchange of a capital asset and that the income from the termination is ordinary income, citing Leh v. Commissioner, 260 F.2d 489, (9th Cir. 1958), and Commissioner v. Pittston, 252 F.2d 344 (2nd. Cir. 1958), cert. denied, 357 U.S. 919(1958).

Pittston concerned the cancellation of a contract to purchase coal. In Pittston, the Tax Court discussed previous decisions concerning the cancellation of a contract. According to Pittston, the key factor in the previous cases was whether the contract right was "property" rather than a naked contract right. In the case of "property", the courts have deemed, in some instances, the cancellation of a contract as a sale or exchange, but have found no such sale or exchange in the case of a naked contract right.

Leh concerned a contract to purchase gasoline. Leh also differentiated a naked contractual right from an interest in property, and held, citing Commissioner v. Starr Bros., 204 F.2d 673, (2nd Cir. 1953), that the cancellation at issue was not to be considered a sale or exchange. The termination of the contract was a "release of...contract obligations... They were not transferred to the promisor; they merely came to an end and vanished." Leh, at 494, citing Starr, at 674.

More recent cases have applied a slightly different rule. In Commissioner v. Ferrer, 304 F.2d 125 (2nd Cir. 1962), the taxpayer leased "the sole and exclusive right" to produce a play. Subsequently, the taxpayer signed an agreement conveying the film rights to the play to a producer and cancelling his contract right. The court held that such cancellation should

be considered a sale or exchange. In Foote v. Commissioner, 81 T.C. 930 (1983), it was held that an agreement cancelling the taxpayer's tenure did not constitute a sale or exchange. The court distinguished Ferrer, stating that Ferrer involved the release of motion picture rights "that could have been sold to any third person." See also Billy Rose's Diamond Horseshoe, Inc. v. U.S., 448 F.2d 549 (2nd Cir. 1971).

The determinative factor in the above cases appears to be whether the contract that is cancelled involves a property interest or a naked contract right and whether the rights involved could have been sold to any third person. However, it should be noted that the Ferrer decision runs contrary to published Service position. As stated in G.C.M. 38314, [redacted], EE-80-78 (March 20, 1980):

> The Service however, has not accepted the approach adopted in Ferrer. Rather, the Service has relied on the "extinguishment doctrine" to argue that a transaction like the one in Ferrer does not qualify as a "sale" or "exchange" of a "capital asset" within the meaning of section 1222. The "extinguishment doctrine" represents published Service position as announced in Rev. Rul. 56-531, 1956-2 C.B. 983, Rev. Rul. 58-394, 1958-2 C.B. 374 and Rev. Rul. 72-85, 1972-1 C.B. 234. The "extinguishment doctrine" asks whether a contract right is a sufficiently substantial property right to survive the transaction, so that it continues to exist in the hands of the transferee.

Moreover, in 1981, Congress added section 1234A to the Code which provides, in part, that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property which is a capital asset in the hands of the taxpayer shall be treated as a gain or loss from the sale of a capital asset. Section 1234A applies to property acquired or positions established after June 13, 1981.

As you cited in your request for Technical Advice, the Senate Finance Committee Report, in adding section 1234A, stated the following:

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> The definition of capital gains and losses in section 1222 requires that there be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss....
>
> The committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductible ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gains. These transactions already cause significant losses to Treasury....
>
> Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities....
>
> This provision applies to property acquired and positions established by the taxpayer after June 23, 1981.

S. Rep. No. 144, 97th Cong., 1st Sess, 170-171 (1981).

The above quoted language indicates Congress' recognition of a problem area, and its legislation to cure the problem. In enacting this legislation, Congress stated that it was changing prior law, and that such changes apply only to property acquired after June 23, 1981.

In your request for Technical Advice, you cited Hoover Company, 72 T.C. 206 (1979), as authority for finding the presence of a sale or exchange, since in Hoover the settlement of a foreign currency contract by the offsetting of identical purchase and sale contracts was found to be a sale or exchange. However, Hoover concerned a settlement, and not a release or cancellation, and Hoover specifically did not rule on a cancellation. Hoover, at 249, fn. 7.

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Therefore, given that the contracts at issue were entered into in [redacted] and [redacted], and based on the fact that the cancellation of the foreign currency contracts extinguishes all rights and obligations of the parties, that any property interest that was created was completely eliminated, the legislative history to Section 1234A, and the Service's history of following the extinguishment doctrine, and despite the transferability of the foreign currency contracts, it is believed that the cancellation of the contracts in question gives rise to an ordinary loss.

The above discussion assumes that the taxpayer's foreign currency contracts were entered into for true business purposes, rather than as a sham. If the transactions could be deemed to be shams, then we believe that the taxpayer should not receive an ordinary loss on the transactions.

The above information is for internal purposes only. A copy shovld not be provided to the taxpayer. Should you have any questions, please contact Ken Cohen at FTS 566-6429 or Ed Cohen at FTS 566-3638.